## INDEX


| | Page |
|---|---|
| Statement | 1 |
| Statement of Facts | 2 |
| Conclusion of Court of Claims | 9 |
| Argument | 10 |
| Law under which assessment was made | 10 |
| Point I. The transaction in question involved merely a financial reorganization and the stock received by appellee was not income nor taxable | 12 |
| Point II. The effect of the transaction is the same as if a stock dividend had been issued. No more income to appellee than if a stock dividend had been received | 24 |


### Cases Cited


| | |
|---|---|
| Eisner vs. Macomber, 252 U. S., 189 | 10, 12, 17, 26, 29 |
| Gibbons vs. Mahon, 136 U. S., 549 | 15 |
| Gulf Oil Co., vs. Llewellyn, 248 U. S., 171 | 27 |
| Peabody vs. Eisner, 247 U. S., 347 | 26, 28 |
| Southern Pacific Co., vs. Lowe, 247 U. S., 330 | 26 |
| Towne vs. Eisner, 242 Fed., 702 | 12, 23, 29 |

IN THE

# Supeme Court of the United States

OCTOBER TERM, 1921.

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**No. 260.**

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THE UNITED STATES, *Appellant,*

*vs.*

C. W. PHELLIS, *Appellee.*

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## BRIEF FOR APPELLEE.

The Commissioner of Internal Revenue on December 31, 1919, assessed Appellee with additional income tax "for the year 1915 because of the receipt by him of said stock (E. I. duPont de Nemours and Company Stock, hereinafter called the Delaware Company), said assessment being in the sum of $5,657.97" (Finding XIII, R. 20).

The stock referred to was received by Appelee on October 1, 1915, under the circumstances hereinafter set forth, and the Appellee having complied with all requirements of law, and having paid the assessment under protest brought his suit in the Court of Claims to recover the amount so paid.

On trial the Court of Claims entered judgment (R. 23) in favor of Appellee (Claimant below) and the United States appealed to this Court.

## STATEMENT OF FACTS.

The Court of Claims found the following facts:

1. Appellee, a citizen of the United States, on and prior to September 30, 1915, was the owner of 250 shares of the common stock of E. I. duPont de Nemours Powder Company, a corporation of the State of New Jersey, and hereinafter called the "New Jersey Company" (Findings I and II, R. 8 and 9).

This Company was and had been for a number of years engaged in the production, manufacture and sale of powder, dynamite, and other explosives, with plants located in the State of Delaware and other States, and in September, 1915, in addition to its preferred stock then outstanding, and its bonds, common stock of the company, of the par value of $100 per share, had been issued, amounting to $29,427,100 (Finding III, R. 9, 10, 11).

2. On the 19th of August, 1915 (Finding III, R. 9) a letter was addressed to the stockholders of the New Jersey Company by its President, stating:

> "The business of the Company has greatly increased in volume, so that it has become necessary to *materially increase our capital to provide for proper and economical operation.* Your officers have given the problem long and serious consideration, *with the result that the Board of Directors have approved a plan for the re-adjustment of its financial affairs,* which may be briefly summarized, as follows," etc. (Italics ours.)

The purpose, as approved by the "Board of Directors" and recommended by the President, was "to materially increase our capital to provide for proper and economic operation," and the great war, referred to by the Solicitor General, then raging, the President and the Directors apparently desired to strengthen the Company, in order that it might discharge its full duty. There was no purpose to then transfer "gains or profits and income" to the stockholders, but as hereinafter shown, to turn all of the assets of the Company including any surplus and cash into *fixed capital,* merely providing for the stockholders' certificates as evidence of an undivided, unsegregated and identically proportionate interest in such assets. The purpose was to fix the assets of all kinds as capital for the purposes of the business and to prevent their being taken out of the treasury of the Company, by distribution to stockholders.

The plan was then set forth in the letter aforesaid, in detail (Finding III, R. 9) and contemplated the organization of a new Company under the laws of the State of Delaware (bringing the business back home) to be known as the E. I. duPont de Nemours and Company (hereinafter referred to as the Delaware Company) and that the New Jersey Company should transfer to the Delaware Company *all* "its property, assets, rights and privileges including the good will of the business," the transfer to be "as an entirety and as a going concern" (Finding IV, R. 13, 14); the Delaware Company "to assume all the liabilities" of the New Jersey Company, and after providing for the exchange by stockholders of the preferred stock of the New Jersey Company, and certain of its bonds for debenture stock of the Delaware Company, common stock of the Delaware Company (a total of $58,854,200), was to be issued to the New Jersey

Company of the par value of $100 per share, and in an amount double that of the outstanding common stock of the New Jersey Company.

The plan further contemplated that each stockholder of the New Jersey Company should continue to hold his common stock, and in addition thereto receive for each share of the common stock held by him in the New Jersey Company two shares of the common stock of the Delaware Company.

The stockholders of the New Jersey Company assented to the aforesaid "plan for readjusting the financial affairs of that Company" in order to "materially increase our capital to provide for proper and economical operation," and to "the transfer of all of the property, assets, rights and privileges" of the New Jersey Company "as an entirety to E. I. duPont de Nemours and Company," of Delaware (Finding III, R. 11, 12).

3. As the result of the proposal and assent of the stockholders, the plan set forth in the letter of August 19, 1915, was carried into an agreement (Finding IV, R. 13) duly authorized by the Boards of Directors of the New Jersey Company and the Delaware Company, reciting that the New Jersey Company, "with the written assent of the holders of more than two-thirds of the capital stock * * * has offered to sell and convey" to the Delaware Company, the real, personal and mixed property of the New Jersey Company *"as an entirety and as a going concern"* for $120,000,000, payable in cash ($1,484,000) and in the capital stock of the Delaware Company, and also reciting that the Board of Directors of the New Jersey Company had ascertained that the "real, personal and mixed property aforesaid are of the

fair value of $120,000,000." The effect of this was to convert all of the assets *into fixed capital,* with stock certificates issued against the same, and to the value thereof.

The New Jersey Company then agreed to transfer all of its property, "real, personal and mixed," all its cash, accounts, and "all the vendor's property, assets, rights, and privileges, including the good will of the business" (R. 14). The consideration therefor was $1,484,100 cash (which was never really paid, but was retained from the cash then held in the treasury of the New Jersey Company) and $58,854,100 in common stock and $59,661,700 in the debenture stock of the Delaware Company (Finding V, R. 19).

The Delaware Company, as a part of the consideration, agreed "to assume and discharge all the liabilities, debts and obligations, contractual or otherwise, of any kind, nature and description due or to become due" of the New Jersey Company, except capital stock liability and the funded debt which was to be replaced by the debenture stock received from the Delaware Company (R. 15).

4. The transfer of the complete property and assets, cash and good will of the New Jersey Company "as an entirety and as a going concern" was made to the Delaware Company on October 1, 1915, by Bill of Sale (Finding V, R. 16, 17, 18). The Delaware Company delivered to the New Jersey Company 588,342 shares of its common stock of the par value of $100 per share, and 596,617 shares of its debenture stock of the par value of $100, and the New Jersey Company retained $1,484,-100 of the cash which was in its treasury, with which to

redeem its outstanding 5 per cent bonds referred to in the letter of August 19, 1915, and the agreement aforesaid (R. 18, 19).

On October 1, 1915, the New Jersey Company held (Finding VI, R. 19):

a. Cash $1,484,100, with which to pay its outstanding 5 per cent bonds.

b. Debenture stock of the Delaware Company to exchange for the outstanding preferred stock of the New Jersey Company, to wit, $16,068,801.34.

c. Debenture stock of the Delaware Company to exchange for the outstanding 4½ per cent bonds of the New Jersey Company, to wit, $14,166,000.

d. Debenture stock of the Delaware Company in an amount equal to the outstanding par value of the common stock of the New Jersey Company, to wit, $29,427,100.

e. Two shares of the common stock of the Delaware Company for each share of the common stock of the New Jersey Company then outstanding.

Thus all of the assets of the business—capital, surplus, cash, good will and everything owned by the New Jersey Company—were removed from the *possibility* of distribution to the stockholders, and became capital investment for use in the same business operated and conducted thereafter by the same stockholders and officers, under a Delaware charter.

5. As of October 1, 1915 (Finding VII, R. 19), the New Jersey Company distributed to the holder of each share of its common stock two shares of the common

stock of the Delaware Company, and the original holders of the common stock of the New Jersey Company continued each to hold his original shares of common stock in the latter Company.

6. As of October 1, 1915, the Delaware Company took over all of the assets of the New Jersey Company (excepting the cash of $1,484,100), and Appellee received 500 shares of the common stock of the Delaware Company and continued to hold his 250 shares of the common stock of the New Jersey Company (Finding VII, R. 19).

7. The personnel of the stockholders and officers of the two corporations was on October 1, 1915, identical. The *"holders of common stock of said corporations had each the same proportionate stock holding in both corporations"* (Finding VIII, R. 9).

8. The New Jersey Company has held the debenture stock of the Delaware Company to the amount of $29,427,100.00, and has received 6 per cent per annum on said stock which has been paid to the preferred and common stockholders of the New Jersey Company, and which has, of course, been returned as income by said stockholders, and income tax paid thereon (Finding IX, R. 20).

9. The New Jersey Company since October 1, 1915, "has done no business" except (Finding X, R. 20):

a. Collection of dividends on debenture stock of Delaware Company, and payment thereof to its own stockholders.

b. Redemption of its outstanding bonds and exchange of Delaware Company debenture stock for its preferred stock.

c. Holding Delaware Company debenture stock to an amount equal to the outstanding common stock of the New Jersey Company.

The New Jersey Company is not in process of liquidation.

10. The fair market value of the common stock of the New Jersey Company, on September 30, 1915, was $795.00 per share, and the fair market value of one share of the New Jersey Company common stock on October 1, 1915, was $100 per share, and of each share of the Delaware Company common stock $347.50 per share; therefore, the stock held by each stockholder in both companies was worth exactly the same on October 1, 1915, as the common stock of the New Jersey Company held by him was worth on September 30, 1915 (Finding XI, R. 20).

11. The Commissioner of Internal Revenue held that each stockholder of the New Jersey Company received income on October 1, 1915, in an amount equal to the number of shares of the common stock of the Delaware Company received by him, on that date, multiplied by $347.50, and the Appellee was assessed on that basis.*

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*While some few shares of the New Jersey Company stock sold in the market for $795 per share. and Delaware Company stock for $347.50 per share, no considerable part of this stock could have been sold at such figures, and this was the only evidence of valuation used by the Government in the assessment, and was "an unsafe criterion." (Eisner vs. Macomber, 252 U. S., at p. 215.) The book value of the stock was entirely disregarded, and this showed the Delaware Company stock worth not more than par.

If the assessment had been based upon par, as was attempted in Towne vs. Eisner, plaintiff would have been charged with income of only $50,000 instead of being charged with income of $173,750, as he is.

12. The Appellee having paid the assessment under protest brought this suit to recover the amount paid.

## CONCLUSION OF THE COURT OF CLAIMS.

The Court of Claims held, "upon the foregoing Findings of Fact the Court decides that plaintiff is entitled to recover the sum of $5,657.97" (R. 21), and judgment was entered therefor in favor of the Appellee (Plaintiff below).

The Court of Claims based its conclusion and judgment on the ground that there was "no net income arising or accruing" to the Appellee on the transaction, and that no "gains or profits and income" had been "derived" by the Appellee.

The Court said (R. 22):

> "As a matter of fact, if the position of the defendants is to be sustained, the Plaintiff herein instead of receiving an income from the transaction loses $5,657.97, which he must pay from gains derived from a source other than the one in controversy, or out of his original investment."

Further:

> "We think the whole transaction is to be regarded as merely a financial reorganization of the business of the company, and that this view is justified by the power and duty of the court to look through the form of the transaction to its substance."

Further:

> "It seems incredible that Congress intended to tax as income a business transaction which ad-

mittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange it would doubtless be taxable.

## ARGUMENT.

In considering how this transaction is to be understood and construed, involving as it does the transfer of the assets of the New Jersey Company "as an entirety and as a going concern" to the Delaware Company, and the assumption by the latter company of the liabilities of the former, we may refer for guidance to the rule laid down by this court in the case of Eisner vs. Macomber, 252 U. S., 189, at page 213, as follows:

> "We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right in order to ascertain whether he has received income taxable by Congress without apportionment."

We urge that "having regard to the very truth of the matter, to substance and not to form," the stockholder of the Delaware Company "has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment." Eisner vs. Macomber, 252 U. S., 189, at p. 211.

## THE LAW UNDER WHICH THE ASSESSMENT WAS MADE.

The Sixteenth Amendment to the Constitution of the United States provides:

> "The Congress shall have power to lay and collect taxes on *incomes* from whatever source *de-*

> *rived* without apportionment among the several states, and without regard to any census or enumeration." (Italics ours.)

Under this provision of the Constitution no tax could be assessed without apportionment unless the subject taxed was "income," which must have been "derived" by the party assessed.

Under authority given by the Sixteenth Amendment, Congress passed the Act of October 3, 1913, under which this assessment was made, which provides (Section A, Sub-Division 1) for a levy or assessment:

> "*Annually* upon the entire *net income arising* or *accruing* from all sources in the preceding calendar year to every citizen of the United States." (Italics ours.)

The Act (Section B) defines the "net income of a taxable person" as

> "gains, profits and income derived from (1) salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or (2) from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property; (3) also from interest, rent, dividends, securities or the transaction of any lawful business carried on for gain or profit, or (4) gains or profits and income derived from any source whatever including the income from but not the value of property acquired by gift, bequest, devise or descent."

In order therefore to justify the assessment against the Appellee, the 500 shares of common stock of the Dela-

ware Company received by him on October 1, 1915, must have been "income" and the same must have been "derived" by the Appellee, in order to meet the provisions of the Sixteenth Amendment to the Constitution. And, further, the 500 shares must have come within the definition of "net income," provided by Section B of the Act of October 3, 1913, and the share of stock must appear to have been "gains or profits and income derived" by the Appellee from the transaction referred to.

Unless the 500 shares of common stock of the Delaware Company received by the Appellee come within the Sixteenth Amendment, no power existed in Congress to tax the same as income and unless the definition in the Act of October 3rd, 1913, fully covers the 500 shares of stock, the Commissioner had no power to make the assessment.

As was said by the District Court in the case of Towne vs. Eisner, 242 Fed., 702, at page 704, quoted with approval by the Supreme Court in Eisner vs. Macomber, 252 U. S., 189, at p. 202:

> "It is manifest that the stock dividend in question cannot be reached by the Income Tax Act, and could not even though Congress expressly declared it to be taxable as income, *unless it is in fact income.*" (Italics ours.)

In view of the foregoing, we maintain the following propositions:

I.

THE COMMON STOCK OF THE DELAWARE COMPANY RECEIVED BY APPELLEE ON OCTOBER 1, 1915, WAS NOT "INCOME ARISING OR

ACCRUING TO HIM" NOR WAS IT "GAIN OR PROFIT DERIVED BY HIM," BUT THE STOCK WAS SIMPLY THE EVIDENCE OF HIS PRO RATA INTEREST IN ASSETS OF THE COMPANY WHICH IT WAS DETERMINED TO RETAIN IN THE BUSINESS, IN INCREASING THE CAPITAL, UPON "A FINANCIAL REORGANIZATION OF THE BUSINESS," AND WAS NOT ASSESSABLE UNDER THE ACT OF OCTOBER 3, 1913.

The Court of Claims sustained this proposition and said (R. 22):

> "The defendant contends that the New Jersey and Delaware corporations must be regarded as 'separate and distinct legal entities' and that the case is within the rule of Peabody vs. Eisner, 247 U. S., 347. We think the transaction is to be regarded *as merely a financial reorganization of the business of the company*, and that this view is justified by the power and duty of the court to look through the form of the transaction to its substance." (Italics ours.)

The purpose of the transaction is shown by the letter of August 19, 1915 (R. 9), and it was proposed because it was "necessary to materially increase our capital to provide for proper and economic operation." The plan proposed was for "the readjustment of its financial affairs," and it is evident that there was no purpose in the Board of Directors to distribute any part of the assets of the New Jersey Company to its stockholders, but the purpose was to *fix and retain* all of the assets, cash and good will in an operating corporation, *as capital*, and to prevent the distribution thereof to the stockholders, issuing to the stockholders, however, additional

certificates as evidence of the same proportionate interests in exactly the same assets; and the plan contemplated the continued operation of the business "as an entirety," and under a new charter, "as a going concern."

The Board of Directors of the New Jersey Company ascertained that the assets of that Company were of "the fair value" of $120,000,000, and the purpose was to use all of these assets as a capital investment to carry on the *increasing business* of the Company, not to *distribute* any part thereof to the stockholders, but to *prevent* any distribution and to issue to the stockholders additional evidence of their pro rata interest in these same assets.

If upon a valuation of its assets the New Jersey Company had determined that all of the $120,000,000 assets were to be retained as capital, and had issued to the stockholders pro rata common stock based upon this valuation, there could be no contention properly made that the stockholder in receiving such additional common stock had received income, gain or profit thereby. This is admitted *by the* Government in its brief, p. 10.

The Government contends, however, that the fact of incorporation of the Delaware Company and that its common stock is issued to the stockholders of the New Jersey Company renders them liable. There is in substance no difference between an issue of common stock as evidence of pro rata interest in the same assets and business whether issued by the New Jersey Company or the Delaware Company. It is only a question of form. Before the transaction the stockholder's interest was represented by one certificate, afterwards by three, and his *proportionate interest* was the *same* in the *undivided assets* as found by the court below (Finding III, R. 19).

In the case of Gibbons vs. Mahon, 136 U. S., 549, this Court discusses the question of whether a stock dividend is income and payable to a life tenant, and at page 558 says:

> "Money earned by a corporation remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to its stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for 'possible' lack of profits in future years; *or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant so as to secure an increase of the permanent value of its property.*" (Italics ours.)

So it will be observed that the Court indicates that there are three ways that a corporation may deal with its capital and earnings.

The Court then says, page 558:

> "Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein represented by each share, is capital and not income, of that share, as between the tenant for life and the remainderman, legal or equitable, thereof."

The third way of dealing with the assets of a corporation, that is, "to retain portions of its earnings and allow them to accumulate and then invest them in its own works



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or plant, so as to secure an increase of the permanent value of its property" is the method which was adopted in the present case, and speaking of that way, the Court said, page 559:

> "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock representing capital or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; and ordinarily a dividend *declared in stock is to be deemed capital*, and a dividend in money is to be deemed an income of each share." (Italics ours.)

The Court further held:

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all of the corporate property; the aggregate interests therein of all the stockholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones."

The above quotations are applicable to the facts of this case and nothing could more accurately set forth the situation of Appellee, after receiving the Delaware Company common stock.

In the case of Eisner vs. Macomber, 252 U. S., 189, we have the last definition by this Court of the word "income" as used in the Sixteenth Amendment to the Constitution and in the Tax Act.

At page 207 this Court adopts the definition of income as "the gain derived from capital, from labor, or from both combined," adding thereto, however, "profit gained through a sale or conversion of capital assets." In discussing this definition, the Court said, page 207:

> "Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. 'Derived-from-capital'; 'the gain-derived-from-capital,' etc. Here we have the essential matter; not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, *severed from the capital* however invested or employed, and *coming in, being 'derived,'* that is, *received or drawn by* the recipient (the taxpayer) for his separate use, benefit and disposal; that is income derived from property. Nothing else answers the description." (Italics ours.)

Again the Court said at page 210:

> "Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar—by declaring a 'stock dividend.' This, however, is

no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company *is separated* from the common fund, nothing distributed except *paper certificates* that *evidence an* antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits *so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution.*" (Italics ours.)

Again the Court said at page 213:

> "Thus, the Government contends that the tax 'is levied on income derived from corporate earnings,' when in truth the stockholder has 'derived' nothing except *paper certificates* which, so far as they have any effect, *deny him present participation* in such earnings. It contends that the tax may be laid when earnings 'are received by the stockholder,' whereas he has received none; that the profits are 'distributed by means of a stock dividend,' although a stock dividend distributes no profits; that under the Act of 1916 'the tax is on the stockholder's share in corporate earnings,' when in truth a stockholder has no such share, and receives none in a stock dividend; that 'the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains,' *whereas there has been no segregation of profits,* nor has he any separate certificate representing a personal gain, since *the certificates,* new and old, are alike in what they represent—*a capital interest in the entire concerns of the corporation.*" (Italics ours.)

All of the foregoing quotations from the opinion of this Court are applicable to the facts in this case.

On the 30th day of September, 1915, a stockholder of the New Jersey Company, having one share, held a cer-

tificate which he could sell in the open market for $795.00 per share. This value did not arise or accrue in the preceding calendar year, but was the accumulated value based upon the company's assets. By the "financial reorganization of the business" of the company under which its properties, cash, good will and all its assets were transferred to a new operating company, the same stockholder held on the 1st day of October, 1915, three shares of stock represented by two certificates based upon exactly the same assets, undistributed, upon which his one share of stock in the New Jersey Company was based. There had been "no segregation of profits," there was no "certificate representing a personal gain" to the Appellee, "since the certificates new and old are alike in what they represent—a capital interest in the entire concerns of the corporation." The three shares of stock were worth $795.00, exactly what his one share in the New Jersey Company was worth on September 30, and we submit that the Appellee had no "profit" by the transaction, that there had been no "gain" derived from capital, and that no gain had accrued to him, and that under no proper construction of the real facts of this transaction can it be held that the Appellee has "derived" income from this "readjustment of the financial business of the company."

The purpose of the transaction was "to materially increase our capital to provide for proper and economic operation."

The capital and profits of the New Jersey Company were "so far absorbed in the business" which was transferred to the Delaware Company "as an entirety and as a going concern" that the effect thereof was "to render it impracticable to separate them for withdrawal and dis-

tribution;" and this transaction added "nothing to the interests of the shareholders," and the only change was "in the evidence which represents" the interest of the shareholders in exactly the same assets and business.

The New Jersey Company had at one time a large amount in Anglo-French Bonds, which were afterward paid out to the stockholders by a dividend in kind, and upon which income tax was duly paid. If these bonds were among the assets transferred on October 1, 1915, to the Delaware Company, the position of the Government in this case would be that the Appellee must pay a tax on the common stock of the Delaware Company received by him at its market value, which market value was partly based upon the Anglo-French Bonds; and that thereafter, when the bonds were segregated from the assets of the business and distributed to the stockholders that again the Appellee must pay a tax to the Government upon the market value of these bonds. The effect thereof would be to first tax the stockholders upon the assets represented by the stock certificates of the Delaware Company as a whole, and then tax the stockholder upon these assets when distributed to the stockholders. We submit that this could not have been intended by the Income Tax Act.

As an illustration—an investor bought on the 25th day of September, 1915, one share of stock in the New Jersey Company, for which he paid $795, the then alleged market value of the stock. This stockholder's income from other sources was such that if the present law had then been in effect he would have been required to pay 50 per cent of the income received as a tax to the Government. On the 1st of October, 1915, there were issued to the above investor two shares of the stock of the Delaware Company worth in the market at the time $347.50 per

share, and he still held his one share in the New Jersey Company of the par and market value of $100; the result of which was that he had three certificates representing his investment worth exactly the same amount as he had paid for the one certificate in the New Jersey Company. The Government's contention now is that both shares of the Delaware Company's stock are income, and that one share of the stock must be sold and that the $347.50 realized therefrom must be paid to the Government as income tax, and then the purchaser above mentioned would have left one share of the New Jersey Company worth $100 and one share of the Delaware Company worth $347.50, a total of $447.50, in place of the $795 which he had invested and paid for the share of the New Jersey Company. Yet the Government urges that this purchaser of a share of the New Jersey Company has received in that calendar year by this transaction a "gain" or "profit" on his investment, and that the same has been "derived" and "received or drawn" by the investor, who, on the 25th day of September purchased one share of stock in the New Jersey Company.

It is submitted that this illustration clearly shows the illegality of the collection by the Government from the claimant of the sum involved in this case, on the ground that it was a tax on "income."

Another illustration may be used: The estate of A, deceased, was a large holder of the stock of the New Jersey Company. The estate was in the hands of trustees under the will of A, the income therefrom to be paid to a life tenant and at her death to be divided among the remaindermen, named in the will.

On October 1, 1915, the trustees of this estate who held the stock of the New Jersey Company, and who had as-

sented to the plan of reorganization, received two shares of the stock of the Delaware Company for each share held by them of the common stock of the New Jersey Company. If these shares of stock of the Delaware Company were income when received by the trustees under the will they belonged to the life tenant, but if they represented the corpus of the estate held by the trustees prior to this "financial reorganization of the business of th Company" then the life tenant was only entitled to the income received annually therefrom, and the corpus of the estate—the shares of stock of the Delaware Company—must be divided at the death of the life tenant among the beneficiaries mentioned in the will of A.

If the Government's contention in this case be correct, the corpus of the estate of A holding shares of common stock of the New Jersey Company was worth on September 30, 1915, $795.00 for each share of stock so held.

On the 1st day of October, 1915, the entire corpus of the estate of A, upon the Government's contention, was the shares of common stock in the New Jersey Company worth $100 per share, and the life tenant was entitled to all of the shares issued to the trustees by the Delaware Company, and each one of these shares is alleged to have been worth $347.50. In other words, by the reorganization of the Company the corpus of the estate of A lost over night six-sevenths of its value, and the remaindermen were only entitled to the shares in the New Jersey Company of the par value of $100 per share, whereas the day before they were entitled in remainder to the total number of shares, at $795.00 per share.

The estate of A by reason of the death of the life tenant has recently been divided under the will, and of

course the stock in the Delaware Company was properly treated as part of the corpus of the estate. Can there be any doubt that this stock of the Delaware Company "was capital as well for purposes of the Income Tax Law as for distribution between tenant for life and remaindermen?" Towne vs. Eisner, 245 U. S. 418, at p. 426.

The learned Solicitor General cites the case of New York Trust Company, Executors, etc., vs. Edwards, Collector, decided on August 3, 1921, by Judge Learned Hand in the Southern District of New York, in which the learned Court refers to the case of Phellis vs. United States, recently decided by the Court of Claims, and says with reference to the opinion of that Court:

> "Whatever may be the proper answer to the case, with the greatest deference I cannot follow the reasoning of the learned judge now urged upon me as authoritative. That reasoning is that because the joint value of the old and new shares after the transfer was the same as that of the old shares before, there can have been no income to the stockholder."

The fact that the value of the shares of stock held by the Appellee in this case was exactly the same after October 1, 1915, as the shares held by him prior to that date in the New Jersey Company, was merely *one* of the facts relied upon by the Court of Claims in reaching the conclusion that the Appellee had received no taxable income, gain or profit:

The Court of Claims was fully justified in taking this into consideration in view of the opinion of this Court by Mr. Justice Holmes, in the case of Towne vs. Eisner, 245 U. S. 418, at p. 426, as follows:

"What was said by this Court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons vs. Mahon, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. Logan County vs. United States, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. *It is alleged and admitted that he receives no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before.*" (Italics ours.)

Whatever may be the correct conclusion of the case decided by Judge Hand in which the facts were entirely different from the present case, we submit that it is clear in this case that the Appellee received by the transaction involved no "gains or profits and income," and therefore that the judgment of the Court of Claims should be affirmed.

## II.

## THE EFFECT OF THIS TRANSACTION SO FAR AS THE STOCKHOLDER IS CONCERNED AND SO FAR AS THE BUSINESS WAS CONCERNED, IS THE SAME AS IF A STOCK DIVI-

DEND HAD BEEN MADE BY THE NEW JERSEY COMPANY, AND THE STOCK RECEIVED BY APPELLEE IN THE DELAWARE COMPANY IS NO MORE GAIN, PROFIT AND INCOME THAN IF HE HAD RECEIVED A STOCK DIVIDEND FROM THE NEW JERSEY COMPANY.

The Court of Claims put its decision upon the ground that the Appellee had received no "gains or profits and income" by the transaction, and did not discuss the question of whether the receipt of the stock in the Delaware Company by Appellee should be treated as "a stock dividend." The learned Solicitor General in his brief and the *one* Assignment of Error (Brief, pp. 9, 10), says:

> "The Court of Claims erred in holding that the dividend paid by the New Jersey Corporation to its stockholders in the stock of the Delaware Corporation was a stock dividend and did not constitute income," etc.

This would seem to indicate that the position of the Court of Claims was misunderstood by the Government, for that Court having decided that there were no "gains or profits and income" did not find it necessary to go further and decide that the transaction in effect was the same as a stock dividend by the New Jersey Company.

The Court below took a view of the situation which we think entirely justified, as follows (R. 22):

> "We think the whole transaction is to be regarded as merely a financial reorganization of the business of the Company, and that this view is justified by the power and duty of the Court to look through the form of the transaction to its substance."

In Eisner vs. Macomber, 252 U. S., 189, at page 213, it is said:

> "We have no doubt of the power or duty of a court to look through the form of a corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable without apportionment."

In the court below, the Government contended, as it does here, "that the New Jersey and Delaware corporations must be regarded as "separate and distinct legal entities" and that the case is within the rule of Peabody vs. Eisner, 247 U. S., 347.

We submit that this is a very narrow view of the transaction. The fact that the New Jersey Company and the Delaware Company were distinct legal entities is not a *controlling* fact. It is evident that the entire business of the Company was to be carried on as one enterprise just as it had been before with the intervention of a technical legal entity incorporated under the laws of Delaware.

Exactly the same situation existed in the case of Southern Pacific Co. vs. Lowe, 247 U. S., 330, and this Court, speaking through Mr. Justice Pitney, said at page 337:

> "We base our conclusion in the present case upon the view that it was the purpose and intent of Congress while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the 1st day of March, 1913, to refrain from taxing that which in mere form only bore the appearance of income accruing after that date while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance

identical because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities. While the two companies were *separate legal entities*, yet in fact and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent, and subject in all things to its proper direction and control."

The Delaware Company was simply an agency created by the New Jersey Company to carry on the business theretofore carried on by the New Jersey Company, and all of the assets of the New Jersey Company were turned over to the Delaware Company for that purpose, and the stockholder simply had certificates of interest representing his identical proportionate share in the same assets. The purpose was *not to distribute the assets* to the stockholders as dividends, *but to prevent this very thing* by *fixing* these very *assets as capital*. We submit that "in mere form only" this transaction "bore the appearance of income" to the Appellee, "while in truth and in substance" the Appellee had no greater interest than he had before October 1, 1915.

The case of Gulf Oil Co. vs. Llewellyn, 248 U. S., 71, was also a case where "separate and distinct legal entities" were involved, and the Court said at page 72:

"We are of opinion that the decision of the District Court was right. It is true that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the facts that they were related *as parts of one enterprise*, all owned by the petitioner, that the debts were all enterprise debts due to members, and that the dividends represented earnings that had been made in former years and that practically had been converted into capital, unite to convince us that the transaction

should be regarded as bookkeeping rather than as 'dividends declared and paid in the ordinary course by a corporation.'" (Italics ours.)

The clear purpose had in view by the corporation was to turn all of its business, cash, assets, good will and everything over to the Delaware Company "as an entirety and as a going concern," and the purpose was "to materially increase our capital to provide for proper and economical operation." After the transfer the New Jersey Company "has done no business" (Finding X, R. 20) and the whole "one enterprise" has been conducted by the Delaware Company. All of the assets were to be treated as fixed capital in the business. It is clearly evident that there was no purpose of "segregation of profits" or that any of the assets should be "severed from the capital however invested or employed," but that the entire property of the Company should be used as it had theretofore been used in its business as fixed capital and not to be distributed, and the only difference was that the stockholders should have "three paper certificates representing his same proportional interests in the assets of the Company as before," but the assets were to be fixed so as to "deny him any present participation in the accumulated earnings of the Company."

We submit that the facts in the case of Peabody vs. Eisner, 247 U. S., 347, are so different from the facts of this case that the reasoning of the Court there does not control the question here presented. In that case certain assets of the Union Pacific Railroad Company, to wit, stock of the Baltimore & Ohio Railroad Co. which it held *as an investment*, were taken out of the assets of the Company and distributed to its stockholders. This was "a segregated" dividend of property in kind, exactly the same as when the Delaware Company made a dividend

payable in Anglo-French Bonds, upon which the stockholders receiving the same paid their income tax. The assets of the business in the Peabody case were reduced by the amount of stock distributed, but in the instant case the assets of the business remained exactly the same as they were before the Delaware Company was incorporated, and we submit that this case is not controlled by Peabody vs. Eisner, which involved "a distribution *in specie* of a portion of the assets of the Union Pacific and is governed for all present purposes by the same rule applicable to the distribution of a like value of money."

The whole reasoning of the Court in the case of Towne vs. Eisner, 245 U. S., 418, is applicable to the facts of this case, and while it may be held that the facts here did not show a technical stock dividend, yet in "truth and in substance" the situation of the stockholder and of the assets and business upon which they were engaged was exactly the same, as if there had been a technical stock dividend, and we submit that the case should be held to be within the reasoning of this Court in that case, which was affirmed by the case of Eisner vs. Macomber, 252 U. S., 189.

In the Brief of the learned Solicitor General under the heading, "The Argument From Hardship," it is contended that the enforcement of the assessment against Appellee would create no hardship upon him, and that one share of stock in the New Jersey Company being worth "the full market price of $795.00 per share," that by the "declaration of this dividend the stock had immediately shrunk to $100 per share," and that "it was within his power, and for aught that the record discloses, he exercised that power (which, it is found by the Court,

is not a fact) to sell his stock after the stock sold ex-dividend, for the new market value of $100.

The Brief at page 37 then states:

> "In that event he did not suffer any hardship whatever, for in making up his income account on the debit side he would account for his share of the accumulated profit by admitting a receipt of $695 in value from dividends, and on the credit side he would get a credit for the precise amount of such shrinkage in the value of his stock. Thus he would pay no tax at all. How then was he injured?"

It is quite remarkable that the learned Solicitor General should have overlooked the fact that this assessment is made under the Act of October 3, 1913, and for a loss in decrease of value in the New Jersey stock the Appellee would not be entitled to take credit in making his income tax return, for that Act only allows a deduction from gross income of a "loss incurred in trade." It being therefore evident that the Appellee could have taken no such credit for loss in value of the New Jersey stock, and the Solicitor General being convinced of that fact by an examination of the Act of October 3, 1913, no doubt he will admit the "hardship" that would be suffered by the Appellee, by the affirmation of the Government's contention.

We respectfully submit that the judgment of the Court of Claims should be affirmed.

OCTOBER, 1921.

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# In the Supreme Court of the United States.

OCTOBER TERM, 1920.

THE UNITED STATES, APPELLANT,
*v.*
CHARLES W. PHELLIS. } No. ——.

*APPEAL FROM THE COURT OF CLAIMS OF THE UNITED STATES.*

## MOTION BY THE UNITED STATES TO ADVANCE.

The United States, by the Solicitor General, respectfully moves that this case be advanced for hearing on April 11, 1921.

The case involves the construction and application of a revenue law of the United States, namely, the Income Tax Act of October 3, 1913. (38 Stat. 114.)

The question involved and its importance will appear from the following brief statement of facts:

On and prior to September 1, 1915, claimant was the owner of 250 shares, par value $100 each, of the common stock of the E. I. du Pont de Nemours Powder Company, a corporation under the laws of New Jersey, hereinafter called the New Jersey Corporation. This corporation had then outstanding:

| | |
|---|---|
| 5 per cent bonds | $1,230,000.00 |
| 4½ per cent bonds | 14,166,000.00 |
| Preferred stock (par value) | 16,068,600.00 |
| Common stock (par value) | 29,427,100.00 |

In August and September, 1915, pursuant to a proposal to and assent by the requisite number of stockholders of the New Jersey Corporation a plan was carried out by which a new corporation, known as E. I. du Pont de Nemours & Company, was organized under the laws of Delaware. This corporation is hereinafter referred to as the Delaware Corporation. On October 1, 1915, pursuant to said plan, the New Jersey Corporation sold and transferred to the Delaware Corporation all its assets and received in consideration therefor—

| | |
|---|---|
| Cash | $1,484,100.00 |
| Debenture stock, par value (nonvoting) | 59,661,700.00 |
| Common stock (par value) | 58,854,200.00 |

Under this plan the New Jersey Corporation was to and did pay its 5 per cent bonds in cash, retire its 4½ per cent bonds and its preferred stock by exchanging therefor debenture stock of the Delaware Corporation; and distribute the common stock of the Delaware Corporation as a dividend to the common stockholders of the New Jersey Corporation. The common stockholders of the New Jersey Corporation retained their stock in it and received as a dividend two shares of common stock of the Delaware Corporation for each share held of the common stock of the New Jersey Corporation. The New Jersey Corporation was not then and is not in process of liquidation, but is an existing corporation, transacting no business, however, other than to collect income dividends from its Delaware debenture stock and to distribute the same, but still has all its corporate powers; and only its assets and liabilities existing at the time of

sale were assumed by the Delaware Corporation. The personnel of the stockholders and officers of the two corporations was, at the time of the sale, identical.

Mr. Phellis, the claimant in this case, after the sale received 500 shares of the common stock of the Delaware Corporation and continued to hold his original 250 shares of common stock of the New Jersey Corporation. The fair market value of the common stock of the New Jersey Corporation, the day before the sale of its assets to the Delaware Corporation, was $795 per share; the day after the sale the fair market value of such stock was $100 and of the common stock of the Delaware Corporation $347.50 per share.

The Commissioner of Internal Revenue held that the 500 shares of stock of the Delaware Corporation distributed to claimant was taxable income; claimant, after due procedure, paid the tax assessed, $5,657.97, under protest and brought this suit in the Court of Claims to recover the amount so paid on the ground that the dividend of stock in the Delaware Corporation was a stock dividend and not taxable under the decisions of this court in *Towne* v. *Eisner*, 245 U. S. 418, and *Eisner* v. *Macomber*, 252 U. S. 189. The Government contends that the two corporations are distinct entities and that the dividend of stock of the Delaware Corporation held by the New Jersey Corporation was a distribution in specie of corporate property and therefore taxable income under the decisions of this court in *Lynch* v. *Hornby*, 247 U. S. 339, and *Peabody* v. *Eisner*, 247 U. S. 347.

The Court of Claims, on March 14, 1921, rendered judgment in favor of claimant.

It is most important that this case be heard and decided at the present term of this court, if possible. While the amount involved in this particular case is relatively small, it is a test case and the total amount of taxes involved in the distribution of the stock of the Delaware Corporation by the New Jersey Corporation, and distributions similar in principle by other corporations, is enormous. The Government has collected very large sums of money from citizens under the ruling of the Commissioner of Internal Revenue. This money is held without interest and should be refunded promptly if the view of the Government officers is incorrect. In addition, the ruling of the Commissioner of Internal Revenue as to the taxability of a distribution of this character is based upon a conception of the income tax law which applies to many other features of the law. If this conception is erroneous, it is highly important that this be decided as soon as possible so that necessary changes in the laws may be brought to the attention of Congress.

The Solicitor General has been authorized by opposing counsel to state that they join in the request for advancement of this case.

WILLIAM L. FRIERSON,
*Solicitor General.*
FRANK DAVIS, Jr.,
*Special Assistant to the Attorney General.*

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